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The encouragement of mere consumption is no benefit to commerce because the difficulty lies in supplying the means, not in stimulating the desire for consumption; and production alone furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption.

— Jean-Baptiste Say, *A Treatise on Political Economy*, 1803

UNITED STATES: MONETARY ANARCHY

From discussing politics back to discussing economics. Just as before, though, it remains a dialogue among the deaf. The great majority of economists has its eyes stubbornly focused on apparently positive features for the U.S. economy, like the sharp fall in the oil price, abundantly available liquidity, tame inflation, low and falling interest rates and strong profits.

A minority of economists, in contrast, keeps just as stubbornly stressing that the economy's famous gross imbalances and structural distortions and the associated debt explosion are inexorably undermining economic growth. In this view, the ongoing housing downturn will finally abort U.S. growth and drive the economy into recession, with major adverse spillover effects on consumer borrowing and spending.

Generally, however, optimism distinctly prevails about the U.S. economy. It is not the old buoyant optimism. Yet it is optimism in the sense that some true malaise, like a crash in the asset markets and a recession, let alone a deep and prolonged recession, are absolutely out of the question. Thanks to its superior dynamism and flexibility, the U.S. economy has time and again bounced back smartly from periodic downshifts, and so it will again.

Let us start with the hard facts. For six, seven and more months, U.S. economic data are overwhelmingly surprising on the downside, and moreover, the surprises have been going from bad to worse. Real GDP has successively fallen from 5.6% in the first quarter of 2006 to 2.5% in the second and 1.6% in the third.

That's bad enough, but what rescued the latter quarter from total disaster was a rather quixotic statistical event. While auto firms slashed their output, it soared in the real GDP account, owing to sharp price cuts on gas guzzlers. In this way, falling vehicle output contributed fully 0.72 percentage points to third-quarter real GDP growth, after subtracting 0.31 percentage points. The price index for gross domestic purchases increased 2% in the third quarter, compared with an increase of 4% in the prior quarter.

It is an old wisdom that the scale of the boom excesses essentially determines the severity of the following process of economic and financial readjustment. It has been comfortingly argued that the U.S. housing boom of the last few years has been less fierce than prior booms, which all ended without steep price declines.

Certainly, there are different possibilities of measurement. For us, the most important, and also easiest, measure of excess is the associated credit expansion. The use of credit in the wake of this housing bubble has been simply bizarre, outpacing all past experiences by far. Over decades until 2000, outstanding total mortgages accumulated to $4.8 trillion. In the second quarter of 2006, they amounted to $9.3 trillion. Mortgage growth over the last five years was almost equivalent to its growth over the prior five decades.

The second highly important point to see is that this housing boom was the first one in the United States to impact the economy at a vastly broader scale than just the building activity. As private households, using the

rising house prices as collateral for mortgage equity withdrawals, stampeded as never before into debt to finance additionally other kinds of spending, the whole economy developed into an outright bubble economy.

New single-family homes and multifamily homes rose in 2005 from a trough of fewer than 1.5 million units in recession year 2001 to a postwar high of 2.2 million units. Over the same period, the constant quality price index for new homes rose 30%, and the purchase-only price index of existing homes published by the Office of Federal Housing Enterprise Oversight (OFHEO) rose by 50%.

Boosting the net worth and the borrowing facilities of private households, this drove consumer spending to persistent considerable excess over income growth. In correlation, personal saving plummeted into negative territory, unprecedented for an industrialized economy.

NO REASON TO WORRY?

It was a boom that plainly went to extraordinary excess in various ways. As a rule, this suggests a very severe aftermath of painful corrections. The first effects of the housing bust have definitely been bigger and more abrupt than most experts had expected. Yet hopes are riding high for a benign adjustment. To quote Federal Reserve Vice Chairman Donald L. Kohn from a recent speech: *"The economy will grow at a moderate pace for a while, somewhat below the rate of increase of its potential, and then growth will begin to strengthen."*

Among his comforting arguments were *first*, the overbuilding in 2004 and 2005 was small enough to be worked off over coming quarters; *second*, this situation stands in sharp contrast to some past downturns in the housing markets that followed actions by the Federal Reserve to tighten credit conditions; *third*, as the inventory overhang in residential building and automobiles are worked off, economic growth should pick up again.

Mr. Kohn does not even mention that through the cash-out refinancing boom, this housing bubble had unprecedented spillover effects on the economy as a whole. In 2005, private households raised $1,080 billion through mortgages. Of this amount, they only spent $95.1 billion on higher residential building. Spending on goods and services rose altogether by $539.9 billion, against an increase in disposable income by $354.5 billion. In other words, about one-third of the increase in consumer spending depended on mortgage borrowing.

Actually, it strikes us how promptly the change in the housing market has impacted mortgage borrowing. It peaked in the third quarter of 2005 at $1,225.9 billion at annual rate. Falling steadily, it was down to $819.6 billion in the second quarter of 2006. This sharp decline was, however, to a small part offset by higher consumer credit.

Mr. Kohn stresses that monetary conditions remain quite supportive of borrowing and spending. Clearly, interest rates are so low that they exert zero restraint on borrowing. But more importantly, falling house prices no longer remain supportive for such borrowing. Remarkably, the sharp decline in new mortgage borrowing since the third quarter of last year has occurred even though house prices were still rising, albeit at sharply slowing rates. As the price climate is sure to deteriorate for some time to come, it seems a reasonable assumption that this initial sharp slowdown in mortgage borrowing has some way to go yet.

While this suggests further sharp falls in house prices, this may well take some time to materialize, because the housing market is notoriously sluggish in its reactions. In contrast to financial markets, its initial response to a change in the market situation is not in price, but on how long unsold homes stay on the market until the prices are lowered to realize desired sales. Sellers tend to resist downward price adjustments as long as they can. Instead, the market becomes illiquid. For sure, lenders will notice and adjust their lending conditions.

Mr. Kohn also takes comfort from the fact that the present housing downturn, in sharp contrast to past ones, is not caused by credit tightening. As he rightly stresses, *"The Federal Reserve has returned short-term interest rates only to more normal levels and long-term rates are unusually low relative to those short-term rates."* We think, though, that he is drawing a totally false conclusion. All downturns caused by tight money

were followed by vigorous recoveries. A downturn happening despite low interest rates and loose money seems to us the most worrying kind.

FAR MORE THAN A HOUSING BOOM

Pondering the implications of this housing downturn, it further has to be taken into account that in contrast to all past experience, this one had a pervasive influence on the whole economy. Past housing booms were confined in their effects to booming housing activity and rising house prices. For the first time, a housing boom additionally involved a major boost to consumer spending, and thereby to GDP growth, as private households borrowed heavily against the so-called wealth effects.

In 2005, this source of borrowing has provided private households with more than $1 trillion. The critical condition was the sharp rise in house prices. As this rise has stalled, the mortgage-refinancing boom is sure to stall in tune with it. As pointed out, this has started with a vengeance.

On closer look, the "wealth effects" from rising asset prices had two effects on the economy. They have been partly monetized to finance higher current spending. But another large part has accumulated in the balance sheets of their owners, with the perception to accommodate later retirement. Thus, higher consumption had its counterpart not only in higher borrowing, but also in unrealized capital gains, being conceived as savings for the future.

There is, therefore, every reason to ponder two possible or probable effects of stagnating or even falling house prices. One is the stop to borrowing for immediate consumer spending, and the other one is, sooner or later, repercussions to the saving rate of private households. There is sure to arrive in the near future the point at which people will realize the need to save out of current income.

In 2005, with real disposable income growth of private households down to just 1.2%, only a steep fall in personal savings from $174.3 billion in the prior year to -$34.8 billion sustained consumer spending. For us it was a self-evident assumption that real incomes would and could not significantly accelerate, given the housing downturn. According to original estimates, they rose 1.7% at annual rate in the first quarter and 1% in the second quarter.

But with the publication of the third-quarter GDP in late October — one week before the elections — there appeared drastic upward revisions in real income growth. Now it is 4.6% for the first quarter, 1.7% for the second and 3.7% for the third. This happened while real GDP growth slumped from 5.6% to 1.6%. All of a sudden, real income growth has been surging.

In any case, this relates to the past. The labor market is a notoriously lagging indicator. In October, employers added 92,000 jobs, of which only 58,000 were private jobs. The decisive question to ponder about the U.S. economy today is where the higher spending may come from to maintain the U.S. economy's growth while housing slumps and consumer spending slows.

THE GREAT NOVELTY: LIQUIDITY CREATION THROUGH ASSET MARKETS

There seems to govern a general assumption that abundantly available liquidity and fairly low interest rates are the infallible assurance against a major economic downturn and that, in any case, the Fed has it in its hand to counter it with rate cuts. In short, there is tremendous faith that the Fed has the economic activity and the financial system under control. In our view, this only creates a false sense of security.

We do not share this faith. In past years, the U.S. economy was given an unprecedented dose of fiscal and monetary stimulus, resulting in an unprecedented explosion of debt. Yet what it achieved was the U.S. economy's most anemic and most imbalanced economic recovery in the whole postwar period.

While this policy overstimulated residential housing and consumer spending, it has grossly failed to

restore an adequate rate of business fixed investment. Personal savings collapsed into negative territory, and the trade deficit doubled to monstrous size.

It is one of the key postulates of Austrian theory that the most harmful effects of credit inflation are not in the price indexes, but in the misdirection of resources that it causes. For American economists, lacking any understanding of this part of the inflationary process, all these structural distortions are irrelevant.

To be sure, over time they impinge on economic growth in various ways. The lowest interest rates in half a century and the biggest fiscal stimulus in U.S. history during 2002–04 have given the economy a one-off boost, but the resulting recovery plainly lacks any self-sustaining and self-reinforcing traction.

It has to be realized further that over the past 10 years, the U.S. economy has undergone a dramatic transformation in the relationship between the economy and its asset markets. In days past, movements in asset prices largely reflected underlying economic activity and fundamentals. The target of monetary policy and the main focus of attention was the economy.

This relationship has been turned on its head. There is no secret as to how the Greenspan Fed pulled it off in 2001. Greenspan deliberately turned to asset markets as the primary target of monetary easing to generate borrowing and spending. It was all about replacing the popping equity bubble with an array of new bubbles, enabling private households to embark on their greatest borrowing binge in history.

By the way, we doubt that he specifically wanted the housing bubble. His problem in 2003 was that the recovery had an unusually weak start. Real GDP grew by 0.2% in the fourth quarter of 2003 and by 1.2% in the first quarter of 2003, both at annual rate. It looked like a relapse of the economy into recession.

With short rates already at unusual lows, he also wanted the lowest possible long-term rates, which he, indeed, achieved. By talking about deflation and expressing a public commitment to hold the federal funds rate at its low, Mr. Greenspan succeeded in unleashing a general stampede into the purchase of long-term bonds. The yield on the 10-year U.S. Treasury bond fell to 3.1% in mid-2003, the lowest in 4 1/2 decades. Essentially, the Fed had to accommodate this run with the necessary liquidity.

To be sure, Mr. Greenspan had hoped that his record rate cuts would give the economy a broad stimulus, spurring both consumption and business investment. This was his fatal miscalculation. Housing and consumer spending, in particular on durables, reacted vehemently, but business fixed investment has remained lackluster. Another area where activity virtually exploded was the financial markets, driven by heavily leveraged carry trade.

This is America's great novelty. Credit and money creation used to occur strictly in line with current spending in the economy, either on business investment, building or consumption. In essence, this set narrow limits. During the past few years, rising values of all kinds of assets have played the key role in creating unprecedented floods of credit and liquidity vastly in excess of the needs for production.

The fact to see is that the Fed readily accommodates any asset inflation and credit inflation that it requires. For good reasons, Mr. Bernanke declared in his recent speech in Frankfurt that a heavy reliance on money supply measures *"would seem to be unwise in the U.S. context."* The U.S. economy and its financial system have become the virtual Moloch, requiring appalling floods of credit to stay afloat.

ALL BUBBLES POP IN THE END

While this system has worked for two full decades, it should nevertheless be clear that asset prices cannot rise to the sky. In order to sustain bubble-driven spending of any kind, asset prices have to be kept inflating. Because that is impossible, all asset and credit bubbles pop in the end, whether pricked by tight money or by exhaustion.

We read that in the wash of liquidity and decade-low interest rates, the bottom of the U.S. housing boom will come sooner than in prior downturns of housing booms. This seems to be a widespread assumption. But

the problem is that a bottoming of house prices is not enough to stop or even reverse the housing downturn. The key condition for the whole housing bubble and the economy's recovery has been that the rising house prices with their famous "wealth effects" provided the equity and the collateral for the extraordinary borrowing-and-spending binge that propelled economic growth.

Absent new sharp rises in house prices, this former ample liquidity creation through this channel remains dead in the water. Liquidity is still awash for other asset trades. See the bond and stock bubbles. Wall Street is again paying record bonuses. But liquidity for housing is in the process of collapsing for the simple reason that stagnating or falling house prices no longer deliver the necessary collateral for this purpose.

Another question is how stagnating, or even falling, house prices will affect the stock market. We read that investors will recycle funds into stocks, thus lending new vitality to the U.S. equity market. But there will be no funds to recycle, because for every dollar wanting to exit the housing market, there must be a buyer to accommodate the exit. In the aggregate, all money is locked in.

Yet there exists still a second major liquidity source for private households that is also of most unusual nature. That is Corporate America's borrowing binge for the stock buyback and merger mania, running at record levels. During the first half of 2006, stock repurchases exceeded stock issues by $550 billion. These stock purchases accounted for the bulk of corporate borrowing. The main recipients of this large stream of money were private households and institutional investors.

Liquidity is awash globally as never before in history. But the source and also the location of this excess liquidity have radically changed in comparison with the past. Credit creation always used to make its way directly into the economy through financing of consumer spending by private households or investment spending by businesses.

Liquidity accumulated to the limited extent that the former saved part of their current income and the latter from retained earnings. Plainly, credit and liquidity creation were closely tied to the rate of economic growth. Financial institutions acted in this process as intermediaries between saving private households and investing businesses.

Manifestly, the relationship between the financial system and economic activity has radically changed. This started in the 1980s and was strikingly visible at the time in the fact that money and credit growth rapidly escalated in relation to GDP growth. It puzzled the Fed and most people that consumer price inflation nevertheless continued to decline. With the benefit of hindsight, we know that credit inflation and price inflation has shifted from consumer prices to asset prices. By the way, it also happened to be the beginning of the U.S. trade deficit.

First gradually, then frenetically, the financial system turned into an autonomous engine of credit creation for no other purpose than to profit from inflating asset prices. As we all know, it proved a most lucrative new business for the participants, far more lucrative than financing economic activity. Given the tremendous size of asset markets in the United States, credit demand for this purpose is virtually unlimited.

For the actors, it has three great advantages: *first*, it automatically creates the collateral for more and more borrowing; *second*, thanks to the rising prices, it is self-sustaining and self-reinforcing; and *third*, the Federal Reserve, too, loves this inflation.

AN APOCALYPTIC IMBALANCE

It took us some time to realize the tremendous economic and financial implications of this first gradual, but finally radical, change in monetary transmission under the Greenspan Fed. Basically, credit and liquidity creation has largely decoupled from economic activity. The central bank accommodates unlimited credit demand for asset purchases, which, in the past, had their limiting source in available savings.

Borrowing against rising prices of all kinds of assets has flooded the U.S. economy and its financial system in the past few years with unprecedented streams of money. Its essential counterparts are steep increases in overall indebtedness. But since asset values rose faster than the debts involved, this has generally been appreciated as a healthy process of wealth creation.

One outstanding result is that all four domestic sectors of the U.S. economy — private households, businesses, government and financial institutions — have been spending vastly in excess of their current revenues. This is unprecedented in history.

Also unprecedented in history is the fact that a large industrial economy has completely abolished domestic saving, being the normal foundation of financial systems. As a result, the performance of the huge U.S. asset markets has become completely dependent on capital inflows and financial leveraging — investing with borrowed money.

It used to be a truism among economists that interest rates in every country are determined by the relationship between savings supply and credit demand. Federal Reserve mandarins and most economists like to assert that U.S. policy has been guided by the goal of the "natural" or "neutral" interest rate, as famously postulated by the Swedish economist Knut Wicksell, being so to say neutral toward economic activity.

While Mr. Greenspan admitted that this rate of interest is only recognizable in hindsight, the Swedish economist gave a precise definition of what this interest rates implies: *"The rate of interest at which the demand for loan capital and the supply of savings exactly agree, and which more or less corresponds to the expected yield on the newly created capital, will then be the normal or natural rate."*

In this connection, he also provided a precise definition of "saving" in the macroeconomic concept, and as unreservedly accepted by generations of economists: *"The accumulation of capital consists in the resolve of those who save or abstain from the consumption of part of their income in the immediate future. Owing to their diminished demand, or cessation of demand, for consumer goods, the labor and land which would otherwise have been required in their production is free for the creation of fixed capital…"*

This strict definition of saving, too, widely disputed in America today, has been a truism among knowledgeable economists for generations. It says that all credit growth in excess of available savings is, by definition, inflationary.

Considering today's horrendous discrepancy between the two aggregates, it seems an absurd assumption. But this balance between saving and credit was reality until the later 1960s, which was America's "golden" postwar era. In 1965, a year we picked by random, domestic credit growth of $78.5 billion compared with net national savings of $79.2 billion. Given domestic savings in excess of the credit expansion, the economy ran a current account surplus of $5.4 billion.

Now compare this well-balanced relationship between credit and saving in 1965 with the preposterous imbalance between the two that has developed in the past few years. In 2005, total credit in the United States exploded by $3,350 billion against a trickle of $7.2 billion in U.S. national savings.

We are tempted to describe this as sheer monetary anarchy, reflecting a monetary system that knows zero restraint for borrowing and lending. Not surprisingly, the U.S. economy ran a current account deficit of $791.5 billion in 2005. Given the astronomical credit expansion, it is astonishing it is not even much higher.

The obvious reason is the fact that a large and rapidly growing part of the credit expansion is not for spending in the economy, but for two financial purposes. One is escalating Ponzi finance — in other words, funding of unpaid interest; and the other is rampant credit creation for purchases of all kinds of assets — bonds, stocks and real estate.

The imbalance between credit growth and available national savings in the United States is apocalyptic. It reveals a credit machine that is completely out of control.

INFLATION WITH 3 DIFFERENT FACES

Credit excess is so completely out of control that it raises the question of why the U.S. economy's inflation rates are not much higher than they are. First of all, thanks to various statistical tricks, they are considerably understated. But more importantly, in a world of huge capital flows, the conventional price indexes have become a much too narrow measure of inflation.

In this world, which has developed since the early 1980s, a larger and larger part of credit excess has been going into the exploding U.S. trade deficit and asset trading. Highly leveraged proprietary trade in existing assets and financing the same trading by others today is the key source of profits for the financial system.

In the world of yore, as already pointed out, businesses borrowed exclusively for investment spending and private households borrowed exclusively for spending on consumption or housing. The implicit result was a strong correlation between credit expansion and increases in spending, incomes and inflation rates. Under these conditions, inflation rates quite correctly tended to reflect existing credit excess and equating inflation simply with rising prices of goods and services was a quite reasonable shortcut in defining and measuring inflation.

In contrast to the simplistic approach in the United States, the leading economists in Europe have always strictly distinguished between the cause and effects of inflation. The invariable cause is credit growth in excess of available savings. By definition, inflation essentially reflects a spending excess relative to output, and this just as essentially on credit excess relative to output. Fighting inflation implies fighting credit excess.

What has radically changed since the early 1980s is the purpose of borrowing, a change that in the United States in particular has gone to formerly unimaginable extremes. In the old world, asset values were determined by changes between credit demand and the available savings. In the new world without savings, asset values are determined by the extent of carry trade.

The Federal Reserve principally disregards carry trade and asset prices. If only the conventional inflation rates of goods and services remain low enough to keep money easy, the two may increase without any limit. They have done so.

Or take the trade deficit. American policymakers and economists refuse to see any connection with domestic inflation. In reality, it is common knowledge that such a deficit basically reflects an excess of domestic spending over domestic output. This is precisely the regular cause of rising prices, conventionally called inflation.

The trade deficit is simply the alternative symptom of an inflationary spending excess. In fact, these tend to show first in a deteriorating trade balance and only later in rising prices. Under the gold standard, monetary policy was, for good reasons, guided by movements in the trade balance.

In essence, a trade deficit diverts excessive domestic demand to other countries. If they have the necessary production capacities, they will like it. But in the case of the deficit country, the effect is to suppress domestic price inflation, and considering the U.S. trade deficit's egregious size, this effect of lowering domestic inflation is implicitly of massive magnitude.

But that is, of course, what American policymakers and Wall Street bulls like so much about the trade deficit. By drastically suppressing the U.S.-made demand inflation for goods and services, it allows the Federal Reserve to maintain its extraordinary monetary looseness, additionally fueling asset inflation, or so-called wealth creation.

Nothing could, in light of these facts, be more ridiculous than the current discussion about inflation in the United States. The true measure of inflation is total credit excess in relation to available savings. Another reasonable measure of inflationary credit excess is real GDP growth. In 2005, total credit growth by $3,350 billion compared with real GDP growth of $345.1 billion. For $10 borrowed, there was $1 added to real GDP.

To repeat and emphasize, the imbalance between credit expansion and available savings in the United States is apocalyptic. By excluding both the rampant asset inflation and the huge trade deficit from its policy considerations and focusing solely on the conventional inflation rates, the Fed ends up keeping its money and credit spigots wide open.

FROM REAL TO FINANCIAL WEALTH CREATION

"Asset-driven growth" is the popular label for America's new pattern of economic growth. It is a grossly misleading label, because the driver is not the creation of real assets, but the creation of higher asset values, euphemistically hailed as "wealth creation." Economic reality is the creation of an asset price bubble offering private households vastly increased facilities to borrow.

The net worth of private households — asset values minus outstanding debt — has soared since 2000 from $41.3 trillion to $52.3 trillion. For sure, this has been the most glamorous component in the U.S. economy's recovery. In reality, it has done more to delude than to enrich people. It is "wealth creation" through a stroke of the pen, based on the principle that all assets of the same kind are worth the price of the last trade, however small that trade may be.

It is a principle that in most European countries is repudiated. The governing rule is instead the principle of the lower price. In German, "Niederstwertprinzip." If market price and cost price of an asset differ, the lower one of the two is obligatory for valuation. That is why even in countries with sharp rises in house prices, like France, "equity withdrawal" is virtually impossible and unknown. This is a centuries-old and wise rule both from the micro and the macro perspectives.

The obvious problem with the opposite practice of permitting asset valuation at the price of the last trade is that large price changes in small trades do change asset valuations in the whole economy with astronomic leverage. While the trades as such lack any economically important effect, the associated tremendous valuation effects may impact the economy in a major way. The regular result is unbalanced economic growth. Related sectors overexpand, while other sectors languish.

This leverage works, of course, the same way when prices fall. We have no idea how deep U.S. house prices will fall, but we want to draw attention to the fact that distress selling has the bad habit of causing sharp price declines at minimal turnover. And who will be there in the housing market to exercise the "moral hazard" that people have taken for granted in the financial markets? If needed, there will surely be support for threatened lenders, but there is no way to support hundreds of thousands of owners in trouble.

Next, we have always sharply disagreed with the perception of rising asset prices as "wealth creation." In our view, the publicity that this term has received in recent years has been a deliberate device to delude people about the poor development in the economy, contrasting strikingly with the astronomical "wealth creation" through inflating asset prices.

Economies and people have grown rich because companies have invested in plant and equipment, creating employment and income for the community. Quoting Keynes: "*It is investment, i.e., the increased production of material wealth in the shape of capital goods, which alone increases national wealth*."

In the case of "wealth creation" through rising asset prices, there is no direct gain. For sure, over ages people have grown richer. But to realize the gain, the owners have to sell the asset. Unfortunately, the gain would largely or fully disappear if many people decided to do this. In the case of housing inflation, any gain from a sale will promptly disappear when the owner chooses to repurchase another house of equal quality.

Borrowing against an asset in any case implies to convert capital into consumption. That is true both from the micro and the macro perspectives. Mr. Greenspan implored people to do this because he was desperate to have higher economic growth at any price.

For the economy as a whole, this capital consumption has clearly shown in four correlated effects:* first*, a rising share of consumption in GDP;* second*, a declining share of business fixed investment;* third*, soaring foreign indebtedness, reflecting the soaring trade deficit; and* fourth*, collapsing national savings.

What has really happened is a major change in the economy's allocation of resources away from investment and net exports and toward consumption. To quote Paul Samuelson, America's great postwar Keynesian, from his *Economics* in spirit: *"There are two principal ways one generation puts a burden on itself later or on a later generation. The one is to bequeath it less capital than would otherwise have been the case. And the second one is to bequeath it foreign debts."* Samuelson, by the way, explicitly warns against wealth stimulus to consumption, because it might crowd out investment.

SOFT OR HARD LANDING?

Not so long ago, it was widely agreed that the housing bubble, with its extensive equity withdrawals, had played a key role in driving the U.S. economy's recovery from the 2001 recession. Confronted with a deflating housing bubble, many Wall Street experts have quickly persuaded themselves that this will not be a big deal for the economy. Mr. Greenspan assured in a speech that *"Most of the negatives in housing are probably behind us. The fourth quarter should be reasonably good, certainly better than the third quarter."*

It is a long-held, old-fashioned view of ours that the most important part of any forecast is the associated commentary to substantiate it. In the United States, forecasting is in huge supply, but careful substantiation is in very short supply.

Trying to assess the possible negative impact of the deflating housing bubble on the U.S. economy, we start with a look at the influence in the two preceding years. The two components "personal consumption expenditures" and "residential building" accounted for 81.8% of U.S. real GDP growth in 2004 and even 91.9% in 2005. We think this recognition allows us to conclude that the U.S. economy is extremely vulnerable to a significant downturn in the two aggregates.

For the serious economist, the next question to ask and to examine is the possibility or probability of which other demand component in the economy is prone to take over in creating rising demand for growth. There is really only one single possible alternative, and that is investment spending by the business sector.

That this will happen seems to be the general assumption. Nevertheless, we have yet to come across a serious attempt to explain in some detail why and how this will come about. Our own guess is that business fixed investment will rather join consumer spending to the downside. Having kept a strict lid on their investment spending in the face of strong consumer spending, one can only wonder about the idea that businesses will embark on an investment boom while consumption weakens.

Examining corporate activity in the past few years, we notice that corporations have done everything to boost share prices, but virtually nothing to boost economic growth. Flooding private households with liquidity through stock buybacks, mergers and acquisitions keeps running at trillions of dollars a year.

In contrast, private households are dumping their stock holdings to realize profits. After net selling of $412.3 billion in 2005, it hit $818.8 billion at annual rate in the first quarter of 2006 and $524.2 billion in the second quarter. Corporations themselves are the single driver of the U.S. stock market's bull run.

A CARICATURE OF CAPITALISM

It comes as a shock to compare this frenzied corporate activity in buying their equity with an extraordinary reluctance to spend on capital investment. Mr. Greenspan's tenure at the head of the Fed has turned on its head the natural relationship between borrowing and spending of the household sector against the business sector in generating economic growth.

The *natural* macroeconomic order of capitalistic economies has always been that private households save part of their income and lend the savings to the business sector for productive investment. In short, private households typically run a financial surplus. Businesses on their part do the deficit spending in order to build plant and equipment; and in doing so, they create employment, incomes and wealth.

This pattern is the essential foundation for creating economic growth and prosperity in the capitalist economies. But deficit spending by businesses for investment spending is out in the United States. Ever since the 1980s, the pattern of corporate expansion in the United States has shifted from organic growth through investment spending to purchasing growth through mergers and acquisitions. This shift has gone to unprecedented extremes in the past few years. Lowest-ever corporate net investment compares with highest-ever mergers and acquisitions. That's good for stock prices, but very bad for the economy.

In this way, business borrowing ends up partly or largely in consumer spending. In the past, private households lent their savings out of current income to businesses for investment spending. Today, borrowing heavily for stock purchases, corporations are flooding private households with cash for consumption. The primary intention of these stock purchases, for sure, is to boost share prices. The major macroeconomic effect, however, is to boost private consumption. It is a caricature of capitalism.

Business spending on investment has never really recovered from the slump it went into after 2000, taking a drastic shift toward shorter life in its composition into account. Only investment above the amount lost to depreciations, or net investment, serves to increase the available capital stock.

The figures for net nonfinancial investment are a disaster. In 2005, it was down 50% from its level in 2000. In 2005, gross investment accounted for 15% of GDP growth and net investment for 1.8%. Its recovery during 2004–05, following the prior steep slump, remained far too sluggish for a return to a normal growth pattern.

AMERICA DROPS, ASIA SHOPS?

This headline, except for the question mark, is borrowed from a recent edition of London's *The Economist*. A subtitle said: ***"Thanks to the vigor of Asia's consumers, it is a good time for the American economy to slow."***

This and an associated second article are must-reads because they perfectly reflect the fallacious, wishful thinking in the United States about the economy and its prospects. They reveal a total ignorance of what is causing the Asian export surpluses and the American import surplus.

For years and years, American policymakers and economists have been trumpeting that America's large and growing trade deficit has its main cause in the "growth gap" between the U.S. economy and other major economies. In this view, a trade deficit is virtually a distinction reflecting strong economic growth. Only recently, U.S. Treasury Secretary Henry Paulson expressed himself in this sense.

Historical experience is exactly opposite. As a rule, fast-growing economies have also run an export surplus. Germany and Japan for many years during the postwar period were the most spectacular examples, even with soaring exchange rates. The most spectacular current example is, of course, China. There is, in reality, nothing astonishing about this coincidence. Strong economic growth and a high export surplus simply have one and the same cause, and that is high rates of saving and investment.

The Economist's key point is that in the past several years, China and Asia have grown much faster than the U.S. economy. Using purchasing-power parity weights, America has accounted for 13% of global real GDP growth since 2001, while Asia has accounted for over half of the world's growth over this period. So not the American consumer, but the Asian countries were really the world's engine of economic growth?

The Economist says:

> *The real driver of the world economy has been Asia, which has accounted for over half*

of the world's growth since 2001…

However, the doomsayers argue that Asia's growth has itself been based largely on exporting to America, whereas domestic demand in the region has languished. Their evidence for this is that Asia is running a combined current account surplus of over $400 billion, implying that it is contributing much more to world supply than to demand…

Since 2001, the increase in emerging Asia's trade surplus has added less than one percentage point a year on average to the region's average growth rate of almost 7%. Contrary to the received view, the bulk of Asian growth has been domestically driven.

A chart in the article shows that consumer spending in China has soared by 80% since 2000, while inching up in the United States by only 20%. So why is China running a huge and soaring export surplus while the United States is running a soaring import surplus?

The reason lies in a dramatically different allocation of resources between consumption and investment. In the United States, the share of consumption in GDP in the past few years has risen to 71%. In China, according to official figures, consumption since 1990 has fallen from 50% to 42% of nominal GDP.

But most important are the tremendous differences in the shares of investment spending and its growth rates. In China, investment has lately accounted for 32% of GDP, with an annual growth rate of 28%, thus vastly outpacing the growth rate of consumer spending. While growth rates of consumer spending are much higher than in the United States, they are very low in China in relation to domestic investment spending.

It is perhaps a misnomer to speak specifically of export-driven economic growth in China's case. In reality, it is investment-driven economic growth. Investment spending is the key, driving both strong exports and strong consumption. What in essence happens is that in such countries, the export surplus acts as the safety valve for chronic overinvestment and excess capacity.

What seems to irk many observers is the fact that consumption accounts for a much smaller share of GDP than in the United States. Yes, but investment-led growth provides much faster overall economic growth, and also for consumers. In short, strong investment generates fast growth for all participants, consumers included, as the Germans or Japanese of the elder generation can attest.

Apparently, we should also clarify a point about which there is much confusion. It is the view that investment implies lower consumption. What really happens is that the people who save part of their income do, indeed, reduce their consumption. But by creating employment in the capital goods industries, investment spending creates consumer incomes and consumer spending for workers.

Rather, investment spending is a main source of consumer incomes. Plainly, this source is badly missing in the United States. Far from reducing consumption, investment spending shifts consumer spending from savers to workers. That is what the old economists perfectly understood.

Still, Japan's experience of the 1980s should be a stern warning that there can also be too much investment spending. What in Japan's case ultimately drove investment and exports to unsustainable excess was the domestic liquidity boom, which the Bank of Japan unleashed with its huge dollar purchases. In our view, China is precisely following in the steps of Japan, but with even greater imbalances. A negative demand shock from America could certainly seriously upset the economy.

At the same time, we want to stress that even stronger domestic growth in China may not boost U.S. exports. Decisive for the trade balance is not the absolute rate of domestic demand growth, but its relationship between investment and consumption. The Chinese economy is running a huge export surplus with domestic demand growth of 9%, while the U.S. economy is running a huge trade deficit with domestic demand growth of little more than 3%. This really reveals an unusual weakness of the U.S. economy's supply side.

Plainly, the difference has structural causes. In the case of China, it is the record-high domestic saving and

investment ratios, and in the case of the United States, it is the record-low domestic saving and investment ratios. What turned the U.S. economy into the world's engine of growth was by no means a particularly high rate of domestic demand growth, but an unusually sluggish supply side relative to grossly inflated domestic demand.

America's key problem is the lopsided composition of its demand growth toward consumption, not its overall rate of growth. Consumption weakens the trade balance, and investment strengthens it. A persistently large trade deficit intrinsically represses manufacturing investment, which it particularly needs for higher exports. These and other considerations make us extremely wary of the view and widespread hope that the strong demand growth in Asia may give sufficient impetus to U.S. exports to compensate largely for shrinking consumer spending.

CONCLUSIONS:

The U.S. economy is in danger of a recession that will prove unusually severe and long. By any measure, it is in far worse shape than in 2000–01, while the unraveling of the housing bubble is clearly at hand. It seems that the continuous buoyancy of the financial markets is again deluding many people about the gravity of the economic situation.

The great question is what will happen to the variety of financial-asset bubbles in the United States when the housing bubble bursts and the economy slumps. Apparently, both the bond and stock markets are buoyed by the expectation that the next move by the Fed, sometime early next year, will be a rate cut.

In 2001–02, rapid rate cuts and the developing housing bubble cushioned the effects of the bursting equity bubble and spawned an unusually anemic recovery. This time, there is no alternative bubble for rescue. Instead, the housing bubble is bursting.

Interest rate cuts tend to bolster financial markets. Considering the apocalyptic imbalance between trillions of credit expansion and virtually zero domestic savings, U.S. interest rates are ridiculously low and ought to soar. What has driven them down and holds them down is no secret. It was and is unlimited highly leveraged carry trade, of which a large part is in lower-yielding currencies, in particular the yen, at 0.25%. It has been a main source of dollar strength.

It is the most unusual bull run of financial markets in history, being, in the absence of any domestic savings, completely based on financial leveraging. This essentially means that these markets are extremely vulnerable to any shock. The critical point comes when asset prices stop rising even under loose monetary conditions. Consider the housing bust. Some day, the same will happen to the bond and the stock market.

We presume that this time a U.S. recession would send shockwaves through all financial markets, including the currency markets. Keeping track of the data is more important than ever.

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